the Estate Planner

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Build a stronger ILIT

Protect assets from gift and estate taxes with an irrevocable life insurance trust

Some relief from federal gift and estate taxes is available in the forms of the $1 million gift tax exemption, the $1.5 million estate tax exemption (which increases to $2 million in 2006) and the $11,000 annual gift tax exclusion (which increases to $12,000 in 2006). But, for some, that might not provide enough protection. In fact, for larger estates, federal gift and estate taxes can consume a large portion of the estate.

Thankfully, an irrevocable life insurance trust (ILIT) can shield transfers beyond the $1 million gift tax exemption and the $1.5 million estate tax exemption. Plus, you can fund it with $11,000 annual exclusion gifts. But you must follow the rules to achieve these results.

Plan the structure properly

A properly structured ILIT can save you estate taxes while benefiting your spouse and other loved ones. Because the ILIT owns your life insurance policy and is designated as the beneficiary, when you die, the policy's proceeds are paid directly to the trust and aren't included in your estate for federal estate tax purposes.

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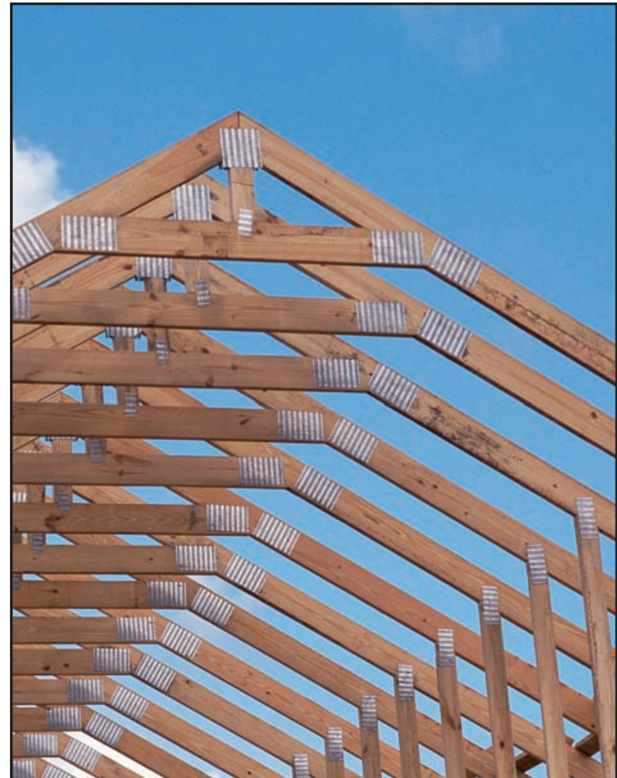
The vital building blocks of an ILIT are:

The policy. One way to fund the trust is to transfer an existing insurance policy to it. The ILIT's trustee — such as your spouse — then signs a change of beneficiary form naming the ILIT as the policy's new beneficiary. In addition, even though



your spouse is the ILIT's primary beneficiary if he or she survives you, the properly structured trust will not be included in your spouse's estate on his or her subsequent death. However, you must live for at least three years after the date you transfer the policy. If you don't, the policy proceeds will be included in your taxable estate.

If you can fund the trust and then have the trust buy a new insurance policy, that's probably a better option. The three-year rule doesn't apply to a policy that's owned from its inception by an ILIT.

Premiums. Open a separate checking account for the ILIT to which you can make deposits. Your trustee can pay the premiums from that account. Your spouse shouldn't make gifts to the ILIT's checking account if he or she is a trust beneficiary, because it may cause a portion of the trust assets to be included in your spouse's estate for estate tax purposes. If you're living in a community property state, you must be especially careful

to avoid having your gift be treated as being made equally by you and your spouse.

Marital deductions. The value of any cash or other property you contribute to the ILIT will be considered a gift for gift tax purposes. Accordingly, the cash value of any policy you transfer to the ILIT and the amount you contribute to pay policy premiums are considered gifts for gift tax purposes.

Your spouse can have the right to withdraw all or a portion of the gift. But his or her right to withdraw contributions has to be limited; otherwise a portion of the ILIT would be included in his or her estate for estate tax purposes. Your spouse's right to withdraw has to be limited to the greater of: 1) the first $5,000 contributed to the ILIT in each calendar year, or 2) 5% of the value of the ILIT.

Gift tax exclusion. If property in excess of those amounts is contributed in any calendar year, additional beneficiaries, such as children or grandchildren, may be given withdrawal rights so the contribution won't be subject to gift taxes. These withdrawal rights let contributions in excess of the amount subject to the spouse's withdrawal rights qualify for the annual gift tax exclusion and not be taxable.

Withdrawal right notices. To protect the gift tax deduction and exclusion, the ILIT must require that each person entitled to make a withdrawal be notified of his or her withdrawal rights. This notice must be in writing unless actual notice already exists. If property in excess of your spouse's withdrawal right is contributed in any calendar year, all beneficiaries age 18 or older should be given written notice. Your spouse, as guardian for your minor children, may have actual notice so written notice may not be necessary, but you may still provide such notice just to foreclose a possible IRS challenge.

Benefit your grandchildren

An irrevocable life insurance trust (ILIT) also can be a great tool for passing assets to your grandchildren. Simply allocate your generation-skipping transfer (GST) tax exemption to gifts you make to the ILIT. By annually allocating an amount equal to your contributions to the ILIT, the insurance proceeds can be kept exempt from GST tax.

Leveraging the exemption this way can significantly increase the amount that can pass estate-tax free on the death of your child (or later descendant) because no estate tax will be incurred on the ILIT assets at that time.

Before 2002, you would have had to allocate GST tax on your annual gift tax return. But beginning on Jan. 1, 2002, new rules allowed the GST tax exemption to be automatically allocated to an ILIT. Thus, filing a gift tax return to allocate the GST tax exemption to an ILIT may not be required.

Be sure to keep records of the amounts you contribute to the ILIT so on your death there is a record of how much of the GST tax exemption you allocated to the ILIT. If you don't want to allocate the GST tax exemption to your ILIT, you'll need to notify the IRS by filing a gift tax return.

Draw up the blueprints

The primary goal of your estate plan likely is to pass as much of your wealth to your family as possible. And even though the IRS provides some gift and estate tax protection on transfers, it may not be enough. Using a properly constructed ILIT can help you protect a great deal more of your assets from gift and estate taxes.

Keeping private matters private

5 ways to structure your assets to avoid probate

Suppose someone told you that after your death much of your personal financial information, as well as a detailed description of who received your assets, would become a part of the public record. Oh, and for the privilege of making all of that information available, you'd incur significant court fees and legal expenses.

Perhaps you'd prefer to save those costs and keep your estate plan private. The good news is that avoiding probate is not terribly difficult.

Probate avoidance strategies

In a nutshell, probate is a court-supervised process to protect the rights of creditors and beneficiaries and to ensure the orderly transfer of assets. But because probate can be time-consuming, expensive and public, you may want to include avoiding probate as part of your estate plan. If so, consider these strategies:

1. Set up a revocable trust. A revocable, or living, trust is a simple way of titling assets so you can avoid the probate process at your death or similar court proceedings if you become legally incompetent. But just creating the trust isn't enough. Until you transfer assets to the trust, it's useless with respect to probate avoidance. Once your assets are re-titled into the trust, though, it becomes an extremely powerful estate planning tool that lies in wait until needed.

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Technically, you no longer own the assets, the trust does; but during your life the trust is virtually disregarded. You have complete control over

the assets — for example, how they're invested, when they're sold and when you spend the funds. All tax-related activity of the funds is still reported on your personal income tax return. In a sense, all you've done is transfer the assets from one pocket to another.

On your death, the trust's assets *are* included in your taxable estate but they *aren't* included as a part of your *probate* estate. Thus, the revocable trust is not designed to avoid, or even reduce, estate tax. It's designed solely to reduce the expenses of administration. That is, it will reduce your probate costs.

2. Hold assets in joint tenancy with right of survivorship. A revocable trust may pack the biggest punch, but perhaps the most popular way for married couples to hold assets to avoid probate is in joint tenancy with the right of survivorship. Here, title in the joint property vests only in the survivor immediately on the death of the other joint tenant.

Although joint tenancy with right of survivorship may be easy to set up, what you gain in simplicity

you can lose in your ability to reduce or even avoid estate tax. For instance, unless your and your spouse's combined estate is less than the estate tax exemption available to one spouse, if in fact all of your assets are owned jointly, then you may have to pay some estate tax on the survivor's death that you could easily have avoided.

Joint tenancy with right of survivorship also is sometimes used when a parent (especially a widow or widower) wants to leave assets to his or her child. But keep in mind that the joint tenant has immediate access to funds in the account. Therefore, if your child withdraws funds from the account prior to your death, you may be treated as having made a taxable gift. Thus, it's vital that you understand the ramifications of creating a joint tenancy, lest you be negatively impacted by an unintended consequence. (For the impact on home ownership, see the Estate Planning Red Flag on page 7.)

3. Establish a life estate. A life estate allows you to continue enjoying all the benefits of owning your property during your life without having the potential issues involved with joint tenancy. Using a life estate accomplishes essentially the same thing as a revocable trust. But it's geared for use with a specific piece of property rather than a variety of assets that would be held in the trust.

At your death, title automatically vests in your remainderperson, such as your child or grandchild, without having to go through a lengthy probate process. Real property is a great candidate for retaining a life estate and transferring the remainder. There are, as with anything, technical aspects of a life estate that will vary depending on where the property is located.

4. Designate retirement plan beneficiaries. Retirement plans with properly designated beneficiaries aren't subject to probate. When you initiated your IRA, 401(k) or other retirement plan accounts, you likely filled out a beneficiary designation form. Even if you know that you provided the custodian with the right information, be sure the form is readily accessible. That way, on your death, there will be no delay in your beneficiaries gaining access to the funds. Plus, retirement accounts have specific rules with respect to distributions in the hands of beneficiaries. A lot of flexibility can be lost if the estate is deemed to be the beneficiary.

5. Designate life insurance and annuity beneficiaries. As with your retirement plan accounts, insurance policies and annuities with properly designated beneficiaries aren't subject to probate. When you purchased a life insurance policy or an annuity you likely designated a beneficiary. Over time, though, situations can change. Be sure to verify that the beneficiary you designated is still the one you want. You should also confirm that you and your heirs know where the documentation is located. If you are unable to find it, or if your beneficiary designation is outdated, be sure to take the time to locate or change it.

Privacy protected, time and money saved

Avoiding probate is easy and can be extremely worthwhile. Whatever steps you decide to take, be sure that everything is properly documented. After all, taking action today to ensure that you're able to avoid probate will allow your family to protect your privacy and will enable your heirs to save time, money and aggravation.

Is your IRA protected against creditors?

Estate planning isn't just about transferring assets to your heirs at a reduced tax cost. It's also about preserving and protecting your wealth for your family. That's why asset protection is an important aspect of estate planning.

If you're like many people, interests in retirement plans — including employer-sponsored plans, such as a 401(k), and IRAs — are among your largest assets. So the extent to which these plans are protected against creditors' claims is critical to your family's security.

Misconceptions about IRA protection

Ever since the U.S. Supreme Court's 1992 decision in *Patterson v. Shumate,* employer-sponsored pension, profit-sharing and 401(k) plans, as well as most other qualified retirement plans, have enjoyed bankruptcy protection against creditors. The court held that qualified plans are excluded from the bankruptcy estate, basing its decision on provisions of the Employee Retirement Income Security Act of 1974 (ERISA). In most cases, this protection also extends outside of bankruptcy.

But IRAs aren't covered by ERISA, so the *Patterson* decision didn't apply to them. Asset protection for IRAs generally has been based on state law, which can vary dramatically from one jurisdiction to another. Most states offer some protection for IRAs, but it's often limited to a modest fixed dollar amount or to an amount reasonably necessary for a debtor's support.

In April of this year, the Supreme Court expanded federal bankruptcy protection for IRAs in the case of *Rousey v. Jacoway.* But contrary to popular belief, *Rousey* didn't extend to IRAs the same protection afforded to ERISA plans. The Court simply held that IRAs qualify for a federal bankruptcy exemption for "retirement assets."

Bear in mind that pre-BAPCPA law will continue to apply to IRAs and other retirement plans if a creditor sues you or otherwise makes a claim against your assets outside of bankruptcy.

The Court's decision in *Rousey* is of limited value. First, the exemption applies only to IRA assets that are "reasonably necessary" for the support of the debtor and his or her dependents. Second, the ruling doesn't apply in states that have opted out of the federal exemption scheme. And third, it's not clear whether *Rousey* applies to Roth IRAs.

Expanded protection under the new bankruptcy law

Less than three weeks after *Rousey* was decided, President Bush signed the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA). Generally effective for bankruptcy filings on or after Oct. 17, 2005, BAPCPA extends the same protection enjoyed by qualified plans to traditional and Roth IRAs and most other tax-exempt retirement funds, up to a $1 million cap.

Under the new law, all IRAs receive the same level of protection, without regard to state law or the debtor's needs. The $1 million cap doesn't apply to rollover contributions from qualified plans, so you can transfer assets from an employer plan to an IRA secure in the knowledge that the entire rollover amount, as well as earnings on those funds, will be protected in bankruptcy. It's also advantageous to place rollover amounts in separate IRAs so funds that are exempt from the $1 million cap are easier to track.

One caveat to consider

Bear in mind that pre-BAPCPA law will continue to apply to IRAs and other retirement plans if a creditor sues you or otherwise makes a claim against your assets outside of bankruptcy. And though bankruptcy may not be a desirable option, it's comforting to know that BAPCPA's protections are available if you need them.

Estate planning red flag

Joint home ownership with a child

You may be considering adding adult children to the title to your home as joint tenants. It can be an appealing strategy because, under the right of survivorship, your home automatically goes to your child after you and your spouse die. There's no need for more sophisticated estate planning, and it avoids probate. (For more on probate avoidance, see "Keeping private matters private" on page 4.)

Unfortunately, joint home ownership can create some unintended, and often unpleasant, consequences that could easily be avoided with a little planning. Possible pitfalls include:

Gift taxes. Adding your child to your home's title may be deemed a taxable gift of a portion of the home's value, which can trigger gift tax liability or use up a portion of your $1 million gift tax exemption.

Capital gains taxes. Property transferred at death receives a stepped-up basis equal to its current market value, so your child can turn around and sell the property with no taxable gain. If you add your child to the title, you may not be entitled to a stepped-up basis for the entire value.

Creditor claims. When you add your child's name to the title, the home is immediately exposed to claims by your child's creditors. Trusts and other estate planning techniques can help protect the home from these claims.

Loss of control. By forming a joint tenancy, you give up control of the property. You can't mortgage or sell the property without your child's approval.

The unexpected. If your child dies before you, the home is back in your name without a plan for its disposition. This can have the unintended consequence of depriving your grandchildren of their enjoyment of the property.

In most cases, you can achieve better results with a simple will or living trust.

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